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July 20, 2007

[via e-mail to:rule-comments@sec.gov](mailto:rule-comments@sec.gov)

Ms. Nancy M. Morris, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

**Re: File No. PCAOB-2007-02
Public Company Accounting Oversight Board; Notice of Filing of Proposed
Rule on Auditing Standard No. 5, an Audit of Internal Control Over
Financial Reporting That is Integrated with an Audit of Financial
Statements, and Related Independence Rule and Conforming Amendments**

Ladies and Gentlemen:

This letter is submitted on behalf of the Committees on Federal Regulation of Securities and Law and Accounting (the "Committees") of the Section of Business Law of the American Bar Association in response to the request for comments by the Securities and Exchange Commission (the "Commission") in its June 7, 2007 release referenced above and in its June 15, 2007 Notice of Additional Solicitation of Comments on the above referenced PCAOB proposed rule (the "Proposal").

The comments expressed in this letter represent the views of the Committees only and have not been approved by the American Bar Association's House of Delegates or Board of Governors and therefore do not represent the official position of the American Bar Association (the "ABA"). In addition, this letter does not represent the official position of the ABA Section of Business Law, nor does it necessarily reflect the views of all members of the Committees.

We believe that the Proposal will enhance the ability of independent registered public accounting firms to exercise judgment in determining the scope of their audits and thereby

decrease the costs of audits of internal control over financial reporting and better focus the attention of the independent registered public accounting firms on the material control risks. The success of the Proposal, however, will depend in large part on the way it is implemented by management, including internal auditors, and by independent registered public accounting firms, as well as how it is applied by the PCAOB in its inspections.

Although we support the Proposal generally, we are concerned that the inclusion as an “indicator of a material weakness” in Paragraph 70 of how a prudent official assesses a deficiency is confusing and appears to set forth a different standard from the items identified as indicators of material weaknesses in Paragraph 69 of the Proposal. The “Guidance Regarding Management’s Report on Internal Control over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934; Final Rule” (the “Guidance”) issued by the Securities and Exchange Commission (the “Commission”) on June 20, 2007 presents the same concerns.

Paragraph 70 of the Proposal identifies an additional indicator of a material weakness not listed in Paragraph 69 by stating follows:

If the auditor determines that a deficiency, or combination of deficiencies, *might* prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles, then the auditor should treat the deficiency, or combination of deficiencies, as an indicator of a material weakness. [emphasis added]

This prudent official standard was not included in the list of “strong indicators of material weaknesses” set forth in Paragraph 79 of PCAOB Release 2006-007 (December 19, 2006) (the “December Proposal”). Rather, the prudent official standard was included in Paragraph 77 of the December Proposal in a discussion relating to the evaluation of the severity of deficiencies. There, however, the PCAOB stated as follows:

If the auditor determines that the deficiency *would* prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles, then the auditor should deem the deficiency to be at least a significant deficiency. [emphasis added]

The Commission’s proposed guidance in Securities Act Release No. 8762 (December 20, 2006) (the “Proposed Guidance”) included the same sentence in footnote 74 of Section II.B.1 of the release rather than in the list of strong indicators of material weaknesses set forth in that section of the release.

Without any explanation for the reason for the change, both the PCAOB and the Commission have now presented the prudent official standard as an indicator of a material

weakness using the weaker word “might” instead of the word “would.” With the word “might,” the prudent official standard seems to require consideration as a material weakness of control deficiencies that are very different from the items listed in Paragraph 69 as indicators of material weaknesses. The items listed in Paragraph 69 as indicators of material weaknesses are conclusions about identified matters: the identification of fraud on the part of senior management, the restatement of previously issued financial statements to reflect the correction of a material misstatement, the identification by the auditor of a material misstatement of the current financial statements under circumstances that suggest that the company would not have identified the misstatement, and ineffective oversight of the financial reporting process and internal control over financial reporting by the company’s audit committee. The prudent official standard with the word “might” is not an indicator based on a conclusion but rather an imprecise subjective judgment.

Our concern is that, notwithstanding the elimination of the word “strong” in describing the indicators, companies will have the burden of proving to the auditors that the listed items, including the additional item added in Paragraph 70, are not material weaknesses. This burden would be especially problematic as applied to Paragraph 70 in light of the lower level of certainty with respect to the new prudent official standard under that paragraph as compared to the other indicators of material weaknesses. We therefore recommend that the prudent official standard be identified as an indicator of a deficiency that is at least a significant deficiency rather than a material weakness. If the Commission believes that a prudent official standard should be retained as an indicator of a material weakness, we recommend that the standard be revised to use the word “would” instead of “might.”

The following are our answers to the specific questions in your June 15, 2007 Note of Additional Solicitation of Comments:

- (1) *Is the standard of materiality appropriately defined throughout AS5 to provide sufficient guidance to auditors? For example, is materiality appropriately incorporated into the guidance regarding the matters to be considered in planning an audit and the identification of significant accounts?*

Paragraph 29 of the Proposal requires the consideration of the quantitative and qualitative risk factors that relate to the financial statement line items and disclosures in identifying significant accounts and disclosures and their relevant assertions but does not explain how qualitative risk factors should be identified. We recommend that the words "quantitative and qualitative" be deleted since they may be confusing and their omission would not adversely affect the provision.

- (2) *Please comment on the requirement in Paragraph 80 that the auditor consider whether there are any deficiencies or combinations of deficiencies that are significant deficiencies and, if so, communicate those to the audit committee.*

Specifically, will the communication requirements regarding significant deficiencies divert auditors' attention away from material weaknesses?

We agree that the auditors should advise the audit committee of identified significant deficiencies and do not believe that such a communication would divert the auditors' attention away from material weaknesses.

- (3) *Is AS5 sufficiently clear that for purposes of evaluating identified deficiencies, multiple control deficiencies should only be looked at in combination if they are related to one another?*

We think that the note to Paragraph 65 of the Proposal -- which makes it clear that multiple control deficiencies should only be looked at in combination if they are related to one another -- is very helpful. We do believe, however, that a revision of the definition of material weakness to address multiple control deficiencies in the same manner would be much clearer.

- (4) *Please comment on whether the definition of "material weakness" in Paragraph A7 (which is consistent with the definition that the SEC adopted) appropriately describes the deficiencies that should prevent the auditor from finding that ICFR is effective.*

In our March 6, 2007 comment letter on the December Proposal, we expressed our view that the definition of material weakness may not achieve the Commission's objective of reducing unnecessary work, particularly given the "reasonably possible" standard as used in Statement of Financial Accounting Standards Board No. 5, "Accounting for Contingencies," and we continue to have that concern.

- (5) *Is AS5 sufficiently clear about the extent to which auditors can use the work of others?*

While AS5 is somewhat clear on the extent to which auditors can use the work of others, we recommend that the PCAOB include in AS5 the applicable paragraphs of AU Section 322 or clarify Paragraphs 16 or 18 of AS5 to say that AU Section 322 applies to more than internal auditors in the context of an audit of internal control over financial reporting.

- (6) *Will AS5 reduce expected audit costs under Section 404, particularly for smaller public companies, to result in cost-effective, integrated audits?*

If implemented as intended, we believe that AS5 should reduce integrated audit costs. We are not in a position, however, to quantify what the reduction might be

and believe that the reduction would be greater if the definition of material weakness were less broad.

- (7) *Does AS5 inappropriately discourage or restrict auditors from scaling audits, particularly for smaller public companies?*

We believe that AS5 appropriately encourages auditors to scale audits for small issuers.

We appreciate the opportunity to provide these comments. Members of the Committees are available to discuss them should the Commission or the staff so desire.

Respectfully submitted,

/s/ Linda L. Griggs

Linda L. Griggs, Chair of the Committee
on Law & Accounting

/s/ Keith F. Higgins

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